

## Internal Revenue Service

Number: **200901028**

Release Date: 1/2/2009

Index Number: 7702.20-00

## Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:4

PLR-135375-07

Date:

September 29, 2008

### Legend

Taxpayer =

State A =

Group B Jurisdictions =

Month A =

Month B =

Month C =

Month D =

Month E =

Month F =

Month G =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

L =

M =

N =

Number R =

Number S =

Number T =

Number U =

Number V =

Number W =

Number X =

Number Y =

Number Z =

Dear

This is in response to your letter of August 3, 2007, as supplemented, requesting a waiver pursuant to § 7702(f)(8) of the Internal Revenue Code for Number R contracts issued by Taxpayer, which because of certain Amendments described below, failed to meet the requirements of § 7702. Further, you have requested that neither the failures nor any corrective actions taken will have any effect on the dates the contracts were issued, entered into or purchased for purposes of §§ 72, 101(j), 264, 7702 or 7702A and will not subject the contracts to any retesting or restating of a new test period under

§§ 264(d), 7702(f)(7)(B)-(E) or 7702A(c). Additional information was submitted in letters dated November 28, 2007, November 30, 2007, December 4, 2007, January 4, 2008, January 25, 2008, February 7, 2008 and September 11, 2008.

## FACTS

Taxpayer is a life insurance company organized under the laws of State A and is licensed to do business in Group B Jurisdictions. Taxpayer is a life insurance company within the meaning of § 816, which files its consolidated federal income tax return on a calendar year basis.

Taxpayer issues a variety of life insurance and annuity products including contracts issued to corporate policyholders. Some of these contracts issued to corporate policyholders were issued in four separate series. The Number R Contracts in these series, which are the subject to this ruling letter, are described below. Series 1 Contracts consist of Number S contracts. They are 1980 CSO L contracts which have been sold since Month D of Year 1 until Month F of Year 6. The bulk of the Series 1 Contracts, Number T, have been sold between Month D of Year 1 until Month B of Year 2. The remainder of the Series 1 Contracts, Number U, have been sold between Month C of Year 2 and Month F of Year 6. The Series 2 Contracts, Number V Contracts, are 1980 CSO M contracts sold from Month D of Year 2 until the end of Month F of Year 6. The Series 3 Contracts, involving Number W contracts, are 2001 CSO M contracts sold since Month A of Year 5 to the end of Month F of Year 6. The Series 4 Contracts, involving Number X contracts, are 2001 CSO N contracts sold between Month F of Year 3 and the end of Month F of Year 6. The Contracts were tested under the cash value accumulation and/or guideline premium/cash value corridor tests of § 7702.

Some or all of the contracts in each series were endorsed with an Amendment (collectively the Amendments) and separately referred to as Series 1 Amendment, Series 2 Amendment, Series 3 Amendment and Series 4 Amendment that guaranteed a value upon surrender under the terms of the Amendment during periods of time that ranged from Number Y years to Number Z years (hereinafter collectively referred to as the Amendment Period) after issue that was higher than the cash surrender value defined in the Contracts. This was accomplished by either defining an amount payable in addition to the cash surrender value or redefining the cash surrender value to include an additional amount (the Amendment Amount). All of the Contracts endorsed by the Amendments are treated as life insurance contracts under applicable state insurance laws. Some Contracts were issued in a form substantially similar to the foregoing but with immaterial variations due to state law.

Taxpayer developed the Amendments to satisfy an accounting requirement. Corporate policyholders requested the Amendments in order to mitigate or eliminate the charge to their earnings that resulted in the initial year when the cash values were less than premiums paid. The effect of the Amendments is to enable the corporate

policyholder to enhance early duration policy values so that the corporation's profit and loss statement is not impacted negatively during the early policy years. The Amendments provide for additional amounts payable at surrender during the Amendment Period that are a function of a return of premiums paid and/or a reduction of the charges assessed as of the date of surrender. This additional amount may be received only on surrender and may not be borrowed against.

The Contracts were designed to qualify as life insurance contracts under § 7702 by satisfying the cash value accumulation test set forth in § 7702(b) or the guideline premium/cash value corridor test set forth in § 7702(c) or (d). Under the cash value accumulation test, the contract's cash surrender value, by the terms of the contract, must not exceed at any time the net single premium that would have to be paid at such time to fund future benefits under the contract. Section 7702(b)(1). Under the guideline premium/cash value corridor test, death benefits must not at any time be less than the applicable percentage of the cash surrender value. Sections 7702(c) and (d).

Taxpayer represents that the Contracts and Amendments failed the cash value accumulation test "by the terms of the contract" and failed the guideline premium/cash value corridor test if they were in the cash value corridor under § 7702(d) during the Amendment Period. The failure was caused by Taxpayer's assumption that the Amendment Amount upon surrender was not included in the cash surrender value of the contract. Taxpayer indicates that the qualification of the contracts depends upon the proper interpretation of the term "cash surrender value" and that § 7702(f)(2)(A) defines cash surrender value for purposes of § 7702 as a contract's "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." Taxpayer further notes that the term "cash value" as used in this definition is not defined in the Code or in final or temporary regulations. Taxpayer further observes that the legislative history of § 7702 provides that "cash surrender value" is defined as "the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend." S. Print No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984). Taxpayer also notes that in 1992, the Department of Treasury issued proposed regulations (the 1992 proposed regulations) (57 FR 59316), that among other things, defined "cash value" generally as the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow. Section 1.7702-2(b)(1) of the 1992 proposed regulations. Section 1.7702-2(h)(2) of the 1992 proposed regulations states that the cash surrender value of the contract generally equals its cash value, as defined in § 1.7702-2(b)(1) of the proposed regulations. Taxpayer also directed our attention to Notice 93-37, 1993-2 C.B. 331, where the Service announced that the effective dates of the proposed regulations under § 7702 would be no earlier than the date of publication of final regulations in the Federal Register and that it was anticipated that insurance companies generally will be allowed a period of time after the

final regulations are published to bring their policy forms into compliance with any new rules.

Taxpayer discovered the error in Month G of Year 4, after reading private letter rulings issued by the Internal Revenue Service in 2005. Those letter rulings concluded, with respect to amendments similar to the Amendments in the present case, that the additional amounts payable upon surrender were considered “cash surrender value” and the resulting increase in cash surrender without a corresponding increase in the death benefits caused the contracts at issue to fail the cash value accumulation test under § 7702(b) and to be disqualified as life insurance contracts. (Although these 2005 rulings involved only the cash value accumulation test, a similar analysis applies to the guideline premium/cash value test under § 7702.)

Taxpayer proposes to correct its practices that caused the failure of the Contracts to satisfy the requirements of § 7702 and by the end of Year 6, Taxpayer will: (a) replace the Series 1 Contract and Amendment with three New Contracts and Amendments that comply with § 7702, (b) discontinue the Series 2 Contract and Amendment, and (c) replace the Series 3 and 4 Amendments with New Amendments that will cause the Series 3 and 4 Contracts and New Amendments to comply with § 7702.

Taxpayer will also put into effect the following with respect to the Contracts:

(1) Where the New Contracts and/or Amendments are not in use or available, Taxpayer will provide a binding letter within 90 days after the date of the waiver, to all policyholders with existing Contracts and Amendments that are within the Amendment Period on the date of the waiver and, at issue, to all policyholders with Contracts and Amendments after the date of the waiver under which letter Taxpayer will commit to include the Amendment Amount in the cash value that is used to calculate any death benefit required to be paid during the Amendment Period under § 7702. Taxpayer will monitor the death claims under these Contracts to assure that the proper death benefit is paid.

(2) For each Contract under which the insured dies during the Amendment Period, Taxpayer will calculate the death benefit under the Contract by taking the Amendment Amount into account as part of the cash value used to determine the death benefit required to satisfy § 7702. If a death benefit already has been paid with respect to a Contract, Taxpayer will pay the beneficiary the difference, if any, between the required death benefit and the death benefit actually paid within 90 days after the date of the waiver.

(3) The New Contracts and Amendments, and any additional contracts and amendments that Taxpayer issues in the future with features identical to or similar to the Contracts and Amendments, will include the additional amounts paid under the

amendments as part of the cash surrender value of the Contracts within the meaning of § 7702(f)(2)(A).

## LAW

In general, for contracts issued after December 31, 1984, § 7702 provides a definition of the term “life insurance contract” for all purposes of the Code. To satisfy this definition, a life insurance contract must be treated as such under the applicable law. Under § 7702(a), the contract must also either (1) meet the cash value accumulation test of 7702(b), or satisfy the guideline premium requirements § 7702(c) and fall within the cash value corridor test of § 7702(d).

Section 7702(b) provides that a contract meets the cash value accumulation test, if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

Section 7702(c) provides that a contract meets the guideline premium requirements if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation as of such time.

Section 7702(d) provides that a contract falls within the cash value corridor if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

Section 7702(f)(2)(A) provides that, for purposes of § 7702, the cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

The common definition of cash surrender value is “the amount made available, contractually, to a withdrawing policy owner who is terminating his or her protection.” Kenneth Black, Jr. & Harold D. Skipper, Jr., *LIFE & HEALTH INSURANCE* 46 (13th ed. 2000); see also John H. Magee, *LIFE INSURANCE* 599 (3<sup>rd</sup> ed. 1958) (“The cash value represents the amount available to the policyholder upon the surrender of the life insurance contract.”)

In relevant part, the legislative history of § 7702 defines cash surrender value as the “cash surrender value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend.” S. Print No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984).

Section 1.7702-2(b)(1) of the proposed Income Tax Regulations provides that, for purposes of § 7702, the cash value of a contract generally equals the greater of (i)

the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that a policyholder can borrow under the contract. 57 Fed. Reg. 59319 (Dec. 15, 1992).

Section 1.7702-2(h)(2) of the proposed regulations provides that the cash surrender value of a contract generally equals its cash value, as defined in § 1.7702-2(b)(1) of the proposed regulations.

In Notice 93-37, 1993-2 C.B. 331, the Service announced that the effective dates of the proposed regulations under § 7702 would be no earlier than the date of publication of final regulations in the Federal Register. The Notice also stated that it is anticipated that insurance companies generally would be allowed a period of time after final regulations are published to bring their contracts into compliance with any new rules.

Section 7702(f)(8) provides that the Secretary may waive the failure to satisfy the statutory requirements under § 7702(a) for a life insurance contract for any contract year if such failure was due to reasonable error and reasonable steps are taken to remedy the error.

## ANALYSIS

The Amendment Amount that could be payable under a Contract and associated Amendment should have been included as part of the Contract's cash surrender value within the meaning of § 7702(f)(2)(A). Because (1) the § 7702 proposed regulation's definition of cash value is not identical to the definition in § 7702's legislative history, (2) the proposed regulations have not been finalized and (3) Notice 93-37 indicates that companies generally would be allowed a period of time after final regulations are published to bring their policy forms into compliance with any new rules, we conclude that the Contracts' failure to satisfy the requirements of § 7702 because the Amendment that could be payable under a Contract was not treated as part of the Contract's cash surrender value within the meaning of § 7702(f)(2)(A) is due to reasonable error. We also conclude that reasonable steps were taken to remedy the error.

## CONCLUSIONS

Based on all of the facts, law and arguments presented, we conclude as follows:

(1) The failure of Number R Contracts to satisfy the requirements of § 7702 because the Amendment Amount was not treated as part of the Contract's cash surrender value within the meaning of § 7702(f)(2)(A) is due to reasonable error and that reasonable steps were taken to remedy the error. Section 7702(f)(8).

(2) Neither the failure nor any corrective actions taken will have any effect on the dates the Contracts were issued, entered into or purchased for purposes of §§ 72, 101(j), 264, 7702 or 7702(A) and will not subject the Contracts to any retesting or restating of a new test period under §§ 264(d), 7702(f)(7)(B) or 7702A(c).

We express no opinion as to the tax treatment of the contracts under the provisions of any other sections of the Code and Income Tax Regulations that may also be applicable thereto.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, such material is subject to verification on examination.

The ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

/S/

DONALD J. DREES, JR.  
Senior Technician Reviewer  
Branch 4  
Office of the Associate Chief Counsel  
(Financial Institutions & Products)